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In the Supreme Court of the United States

OCTOBER TERM, 1962

A. GLENDON JOHNSON, ADMINISTRATOR C.T.A. ESTATE OF A. GALEN JOHNSON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

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No. 384

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v.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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OPINIONS BELOW

The initial memorandum findings of fact and opinion of the Tax Court (R. 27–37) [1] are not officially reported. The first opinion of the court of appeals is reported at 270 F. 2d 134. No findings of fact or opinion was filed by the Tax Court on the first remand. The second opinion of the court of appeals is reported at 284 F. 2d 357. The supplemental memorandum findings of fact and opinion of the Tax Court on the second remand (R. 70–74) are not officially reported. The third opinion of the

[1] "R." refers to the respondent's separately bound Appendix B in the court below.

court of appeals (Pet. App. A) is reported at 302 F. 2d 86.

JURISDICTION

The judgment of the court of appeals was entered on April 27, 1962 (Pet. App. B). A petition for rehearing was denied on May 31, 1962 (Pet. App. C). The petition for a writ of certiorari was filed on August 29, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the taxpayer was entitled to depreciate 25 house plans on the basis of the proportion of the sales during the tax years to the total sales during the depreciable life of the plans.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of Section 23 of the Internal Revenue Code of 1939 and Sections 29.23(l)–1 and 29.23(l)–5 of Treasury Regulations 111 (1939 Code) are set forth in the Appendix, *infra*, pp. 8–10.

STATEMENT

The taxpayer is the administrator, c.t.a., of the estate of A. Gales Johnson, who conducted a mail order service selling house plans based on original designs prepared by him and his staff. At the time of A. Gales Johnson's death, there were in his possession 125 original master plans from which blueprints and material lists were prepared. For estate tax purposes these plans were valued at $173,055,

based on their reproduction value (R. 28–30). Before A. Gales Johnson's death, 25 of these plans had been dropped from current brochures but orders for them were still being received (R. 30). In computing the depreciation deduction on the house plans in his fiduciary income tax return for the fiscal year ending August 31, 1951, the taxpayer removed the 25 plans from the depreciation base and used $173,055 (the estate tax value of the 125 plans) as the value of 100 plans. Using an estimated useful life of 20 years, he claimed a depreciation deduction in the amount of $7,612.75. This was five percent of the asserted value of the 100 plans ($173,055) reduced by an amount petitioners deducted as obsolescence on 18 additional plans ($20,800) which, although printed in the brochures, it was decided were out of favor with the public and should not be carried in the brochures in the future. See *Johnson* v. *Commissioner*, 270 F. 2d 134, 135.

In his notice of deficiency, the Commissioner determined that the 25 plans which were dropped before A. Gales Johnson's death were not obsolete because orders were still being received for them during the taxable years in question (fiscal years 1951 and 1952). Accordingly, he valued the 25 plans at $13,567.51, which was $11,659.99 less than the value ($25,227.50) that had been attributed to them for estate tax purposes, thus reducing the depreciation basis claimed by the taxpayer ($173,055) by $11,659.99 (R. 32–33). The Commissioner's determination in this connection was sustained by the Tax Court because of the tax-

payer's failure to rebut it (R. 35–37). On the first appeal, the court below, reversing in part, held that the depreciation base for all 125 plans was $173,055 (the estate valuation) and gave the Commissioner the option of allocating that amount among the 125 plans according to their reproduction value or of using his $13,567.51 valuation for the 25 plans but allocating the reduction in their value ($11,659.99) among the other 100 plans in any reasonable way. 270 F. 2d at 136. (Of the 100 plans, the Commissioner had determined that 14, instead of the 18 claimed by the taxpayer, were obsolete. The Tax Court and court of appeals upheld that determination (see 270 F. 2d at 136) and the point is no longer in issue.)

On remand, the parties were ordered by the Tax Court to submit computations for entry of decision in accordance with the court of appeals' opinion. The Commissioner filed a computation which allocated the $173,055 depreciation base among the 125 plans, reduced the amount by the amount the taxpayer was allowed to deduct for obsolescence of the 14 plans mentioned above (not included in the 25 plans), and allowed depreciation on the remaining plans over the estimated life of 20 years which the taxpayer had used in his returns for his house plans. A counter-computation and memorandum was filed by the taxpayer urging that depreciation be allowed on the 25 plans at an increased rate based on the sales of those plans. This computation was rejected by the Tax Court, which entered its decision on the basis of the Commissioner's computation (R. 42–59). On the taxpayer's second appeal,

the court of appeals held that the question regarding the depreciation rate was not foreclosed as a new issue and remanded the case for further proceedings. It ordered the Tax Court to determine the proper rate of depreciation on the 25 plans "on the merits, after considering *all* the facts, in order to work out a just result in this difficult situation, even though a large part of the difficulty was created by taxpayer himself." *Johnson* v. *Commissioner*, 284 F. 2d 357, 359.

On the second remand, the taxpayer offered no additional evidence with regard to depreciation on the 25 plans, stating that none was needed (R. 72). Instead, he resubmitted (R. 75–76) the computation previously submitted after the first appeal (R. 42–59), in which he urged that depreciation be allowed on the 25 plans at an increased rate based on the sales of those plans. With no additional evidence on which to make a finding, the Tax Court reviewed the record of the original hearing (which contained no estimates of the useful life of the 25 dropped plans (see R. 72–74)) and found as a fact that the useful life of the plans was five years and the rate of depreciation, accordingly, 20 percent for the taxable years. The court of appeals affirmed (Pet. App. B) and denied the taxpayer's petition for rehearing (Pet. App. C).

ARGUMENT

The taxpayer has not, either in the court below or in this Court, attacked the finding of the Tax Court that the 25 plans had a remaining useful life of five years. Rather, his argument, as the court below stated (Pet. 13), is that he should be allowed to depreciate the 25

plans during the two taxable years on an accelerated basis proportional to actual sales made during the entire depreciable life of the plans. This contention is without merit.

Depreciation, for which a deduction is allowed under Section 23(l) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 8), extends by its very nature over the useful life of the property in the business. See *Massey Motors* v. *United States*, 364 U.S. 92. The Treasury Regulations under the 1939 Code allowed depreciation "in accordance with a reasonably consistent plan" over the useful life of the property including "equal annual installments or * * * any other recognized trade practice, such as an apportionment of the capital sum over units of production." Treasury Regulations 111, Section 29.23(l)–1 and 5, Appendix *infra*, pp. 8–10. We submit that the taxpayer cannot, consistently with the regulations and indeed the basic logic of our revenue system, apportion depreciation on the basis of actual sales over the depreciable life of the plans.

First, the period covered by income tax returns under the tax laws is a single year. The Treasury Regulations provide that the reasonableness of any claim for depreciation is to be determined "upon the conditions known to exist at the end of the period for which the return is made." Treasury Regulations 111, Section 29.23(l)–5. The taxpayer's proposed method of depreciation, however, cannot possibly be computed at the end of an annual accounting period since total sales over a period including subsequent years are obviously unknown.

Second, the Regulations require that taxpayers follow "a reasonably consistent plan" for depreciation. Treasury Regulations 111, Section 29.23(l)-1. Since the taxpayer used the straight line method in the tax years in computing his depreciation allowances on all his other house plans, he was required to use this same method for the 25 plans here in issue.

Finally, the Regulations under the 1939 Code require that, if a taxpayer utilizes a depreciation method other than the straight line method, he must show that it is "a recognized trade practice." The taxpayer here has made no showing of any trade practice of computing depreciation on the basis of sales during the particular year in relation to total sales over the entire life of the asset.

CONCLUSION

For the foregoing reasons, we respectfully submit that the petition for a writ of certiorari should be denied.

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SEPTEMBER 1962.

APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) [as amended by Section 121(c) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

Treasury Regulations 111 (1939 Code):

SEC. 29.23(l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property,

equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. * * *

* * * * *

SEC. 29.23(l)–5. *Method of Computing Depreciation Allowance.*—The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition, and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed.

A taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. * * *

* * * * *